

12 April, 2005

Gavin Francis
30 Cannon Street
London EC4M 6XH
UK

Dear Gavin,

Re: Amendments to IAS 39: The Fair Value Option - Effective date and transitional provisions

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the IASB staff paper "Transition – Fair Value Option" of 23 March 2005. This letter is submitted in EFRAG's capacity of contributing to the IASB's due process. Furthermore, in order to meet your timetable we have had to finalise this letter without consulting publicly on its content. For these two reasons, this letter does not necessarily indicate the conclusions that EFRAG would reach in its capacity of advising the European Commission on endorsement of the definitive IFRS on the issues.

There are two issues to be addressed when commenting on the transitional arrangements: whether the arrangements are satisfactory for the accounting period in which the revised standard is first implemented and whether the arrangements for the comparatives are satisfactory.

- 1) In our view, it ought to be possible under the transitional provisions included in the amended fair value option for an entity to treat the amended version of the option as if, in effect, it has always been part of the December 2003 version of IAS 39. *Alternative A* would not have that effect and is therefore not a satisfactory approach. *Alternatives B and C*, on the other hand, achieve the desired effect. *Alternative C* is our preferred solution; however, *Alternative B* would be also acceptable.
- 2) On comparatives, the principle should be that, whenever possible, information for the period prior to the current reporting period (ie the corresponding amounts) should be comparable to the information for the current period. However, the IASB is proposing that entities shall not be permitted to restate their corresponding amounts to reflect the amendment being made to the fair value option. In our view, this is unsatisfactory. We consider that entities should be allowed to apply the Amendment retrospectively. Alternatively, as a minimum, the transitional arrangements for the fair value option in the December 2003 version of IAS 39 (ie IAS 39.105(a)) should be retained. Although these transitional arrangements do not quite ensure that the corresponding amounts are fully comparable, we think they go as far as is reasonable in the circumstances.

In the appendix to this letter we explain our rationale for the above comments in more detail.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Transitional provisions for the fair value option amendment to IAS 39

The accounting period in which the revised standard is first implemented

We believe that the guiding principle to be applied in considering the transitional arrangements for the accounting period in which the revised standard is first implemented is that they should enable entities to treat the amended version of the fair value option as if, in effect, it has always been part of the December 2003 version of IAS 39.

In other words, if an entity chooses to apply the Amendment from the same date that it adopted the improved IAS 39, it should have a “free choice” over designation in that accounting period. Judged in this way, *Alternative A* is not a satisfactory approach because, if the date of adoption of IFRSs is prior to the date on which improved IAS 39 was first adopted, *Alternative A* would never allow a “free choice” over designation, not even if the entity applies the Amendment from the date it adopts the improved IAS 39. *Alternatives B and C*, on the other hand, do have that effect.

We understand that *Alternative C* would in addition meet the concerns of entities that might wish, when applying the Amendment for the first time, to designate at fair value through profit or loss an instrument that they chose not to designate when applying the improved IAS 39. We understand that, although this might not be a common situation, there are some entities that are in this position.

We acknowledge that allowing “a free choice” to designate under such circumstances creates in theory an opportunity for preparers to redesignate certain financial instruments, and thereby manage their earnings. At the same time, there could be genuine reasons why an entity wishes now to designate a financial instrument that it chose not to designate previously. (For example, it may have before addressed a perceived accounting mismatch by designating an instrument which for various reasons it is no longer able to designate. In such circumstances, it might wish to choose a ‘replacement’ instrument for designation). We think it ought to be possible to address the concerns about earnings management by enhanced disclosures.

Comparatives

When there is a change in an accounting standard, there is often an impact on the comparability of the information provided historically. For that reason, the guiding principle should be that the transitional provisions should wherever possible ensure that the information provided for previous periods is restated so that it is prepared on the same basis as the information for the current period.

For that reason, EFRAG was concerned by the proposal (in paragraph 5(d) of the IASB staff paper) that “entities...shall not restate comparative financial statements.” In our view, entities should not be prevented from applying the fair value option amendment in their comparative financial statements, i.e. applying the fair value option retrospectively.

The retrospective application is especially important for first-time adopters. We are aware that a lot of entities who adopt IFRS in their 2005 annual period have chosen to restate comparative financial statements in respect of IAS 39 even though IFRS 1 *First-time adoption of International Financial Reporting Standards* grants an exemption from such a restatement. Retrospective application of the fair value option would enable entities to

present their comparative financial statements in the most consistent manner with the current accounting period.

We note that if entities could opt for the full retrospective application entities would *have to* restate comparative financial statements for financial instruments designated at fair value through profit or loss in the current accounting period and *might choose* to apply the new designation to those instruments that were derecognized during the comparative period.

We acknowledge that there could be a possibility for entities using the benefit of hindsight to obtain a desired effect on its financial results by recording realized gains or losses on the cost basis or on the realized basis (i.e. shifting those gains and losses between periods) on instruments that were derecognized during the comparative period. However, we consider that the risk of cherry picking is reduced by the requirement in the revised fair value option to link the designation to the accounting policy. The concern could be also addressed by requiring additional disclosure for items in the comparatives to which the fair value option had been applied but which had been closed out prior to the commencement of the period being reported. In general, in our opinion a consistent full retrospective application will enhance the comparison between the periods because similar things would be accounted in a similar way throughout the periods.

We note that paragraph 105 (a) of current IAS 39 requires to restate comparatives of existing in the current period financial instruments to which the fair value option has been applied (IAS 39.105 (a)). It is not clear to us why this requirement would no longer be applicable to the revised fair value option. If the IASB concludes that the risk of cherry picking is so great that full retrospective application is not appropriate, we consider that the requirement in the current IAS 39.105 (a) should be retained as a minimum.